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Post-Mortem IRA Planning For the Surviving Spouse

In 2002, the IRS issued simplified regulations governing required minimum distributions (RMDs) for IRAs. The new rules make elections at the time of one's required beginning date obsolete, and shift the deadline for many of the planning options to a specified date following the IRA owner's death. This article discusses those planning options faced by the surviving spouse.

By Greg Reymann

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On January 11, 2001, the Treasury Department Internal Revenue Service (IRS) issued new proposed regulations under Internal Revenue Code (IRC) Section 401(a)(9). In short, the IRS greatly simplified the rules governing required minimum distributions (RMDs), which are effective in 2002.¹ The new rules make elections at the time of one's required beginning date (April 1 following the calendar year in which one turns age 70½) obsolete, while shifting the deadline for much of the planning options to a specified date following the IRA owner's death.

The New Rules in a Nutshell

RMDs at One's Required Beginning Date

Under the new proposed regulations (the "New Rules"), reaching age 70½ is no longer a traumatic event. Now, with one exception (as described below), when an IRA owner reaches his or her required beginning date, RMDs are calculated using his or her life expectancy and the life expectancy of one who is ten years younger than the IRA owner. This is the same life expectancy used under the Minimum Distribution Incidental Benefit (MDIB) tables.

When one turns 70½, therefore, the life expectancy used for calculating RMDs is either 26.2 or 25.3.² This figure is used whether or not the IRA owner has a designated beneficiary. Each year's RMD is used using the MDIB table, so life expectancy is recalculated for as long as the IRA owner lives.

An exception exists for IRA owners whose sole beneficiary is a spouse who is younger by a difference of more than ten years. I call this the “Michael Douglas” exception. IRA owners like Michael Douglas may still choose to calculate RMDs on the basis of their joint life expectancies with their spouses, and in so doing will obtain a lower RMD than that calculated under the MDIB tables.

RMDs After the Death of the IRA Owner

After an IRA owner dies, RMDs to designated beneficiaries will be based upon the beneficiary’s individual life expectancy (not the MDIB life expectancy), starting no later than December 31st of the year following the year of death. Each RMD thereafter is based on the beneficiary’s life expectancy reduced by one.

If the designated beneficiary is the surviving spouse, and the IRA is kept as is, RMDs are based on the surviving spouse’s life expectancy³ (not the MDIB life expectancy), starting the later of the December 31st following the year of death, or when the deceased would have turned age 70½. This life expectancy is recalculated each year. In the calendar year after the surviving spouse dies, RMDs are made on the basis of the surviving spouse’s remaining life expectancy, reduced by one each calendar year. Of course, the surviving spouse can always roll the IRA over into his or her own IRA, assuming the spouse is the sole beneficiary, and then start taking RMDs when he or she reaches age 70½.

In the case of an IRA with no beneficiary, or a beneficiary with no life expectancy,⁴ RMDs are calculated using the deceased IRA owner’s remaining life expectancy (not the MDIB life expectancy), starting no later than December 31st of the year following the year of death. Each RMD thereafter is based on the remaining life expectancy reduced by one.

Designated Beneficiary Determination

A beneficiary no longer has to be designated by one’s required beginning date, as was the case under the 1987 proposed regulations (the “Old Rules”). Under the New Rules, the designated beneficiary does not have to be determined until distributions to the designated beneficiary must

begin, which is December 31st after the calendar year of death.⁵

Some people have confused this concept, thinking that a beneficiary can be designated after death. An IRA owner must designate his or her beneficiary before death. One of the undesired effects of the New Rules may be that people will become more lax about naming beneficiaries, since there is no longer a requirement to have a beneficiary designation at age 70½.

Post-Mortem Planning Options For the Surviving Spouse

Now that we know the rules, how do we help our surviving spouse client who has just inherited an IRA? One of the beneficial aspects of the New Rules is that the December 31st following the year of an IRA owner’s death, the key date replaces one’s required beginning date in importance. As a result, there is a need for estate planners to understand the impact of the New Rules for their surviving spouse clients.

Separate Share Rule: Correcting Bad Beneficiary Designations

The New Rules permit the separation of IRAs to be made by the December 31st of the year following the IRA owner’s death. To appreciate this impact, let’s first review the “separate share” rule under the Old Rules.

Under the Old Rules, if any of the designated beneficiaries had no life expectancy (such as a charity), a life expectancy could not be used for any of the beneficiaries in which to calculate IRA payments.⁶ For example, if Mr. IRA owner designates the Boy Scouts of America as a beneficiary to \$1,000 of his IRA, and leaves the rest to his spouse, because not all of the beneficiaries are individuals, the spouse could not use her life expectancy to calculate RMD payments if she keeps the IRA as is. The way to avoid this problem was to create separate shares for each beneficiary. Under the Old Rules, the deadline for setting up the separate accounts was either the required beginning date, or the date of death after the RMDs had started.

Under the New Rules, beneficiaries will have until December 31st of the year following the IRA owner’s death to create separate accounts so that

each individual's life expectancy can be used.⁷ So, in the event that one of the beneficiaries has no life expectancy (such as a charity), there is enough time to create separate accounts so that beneficiary life expectancies can be used.

Rolling Over or Keeping as Is

The New Rules did not change the surviving spouse's option of rolling over the inherited IRA into his or her own IRA. If the surviving spouse chooses this option, he or she can start RMDs at age 70½ based on the MDIB table.⁸ In the alternative, the surviving spouse can keep the IRA as is (sometimes referred to as a "deceased IRA"), and make RMDs based on the spouse's actual life expectancy, starting no later than December 31st of the year following the year of death. So which option is better for the surviving spouse? Like everything else, it depends.

If the surviving spouse is the older spouse, it may be better to leave the IRA as is. If the younger spouse was under age 70½, and the surviving spouse is closer to or over to age 70½, then the surviving spouse may want to leave the account alone so that RMDs do not have to begin until the deceased spouse's "70½" year. For instance, if the deceased spouse was aged sixty, and the surviving spouse is aged seventy, by keeping the IRA as is, the RMDs will not have to start for another eleven years. Also, some IRAs may not be protected from creditors under state law. A surviving spouse concerned about his or her creditors may decide it is best to leave the deceased spouse's IRA alone for creditor protection reasons.

In just about all other situations, it is better for the surviving spouse to roll over the inherited IRA into his or her own IRA. By doing so, the surviving spouse will be able to use a joint MDIB life expectancy when taking RMDs, instead of a single life expectancy, and when the surviving spouse dies, RMDs are based on his or her life expectancy, recalculated each year.

Correcting Impermissible Rollovers

Under the New Rules, a surviving spouse is able to roll over an inherited IRA only if the surviving spouse is the sole beneficiary of the account and

has an unlimited right to withdraw from the account. The New Rules also state that the surviving spouse can roll over an inherited IRA if he or she is the sole beneficiary of a trust that is the beneficiary to the IRA. An example in the New Rules clarifies what being a "sole beneficiary" is considered to mean within a trust. In this example, some of the RMDs are accumulated for the benefit of the remainder beneficiaries.⁹ This caused the remainder beneficiaries to be considered beneficiaries of the IRA along with the surviving spouse, which means that a surviving spouse is not considered to be the sole beneficiary and thus cannot roll over the inherited IRA.¹⁰

In the event that the surviving spouse is not considered to be the "sole beneficiary" for the reason that RMDs are accumulated for remainder beneficiaries, there is a way that this can be corrected. Under the New Rules, designated beneficiaries are not identified until December 31st after the year of death. As a result, should the remainder beneficiaries timely disclaim their interest in the trust, as of the December 31st deadline the surviving spouse would be the sole beneficiary under this trust; therefore, he or she would have the ability to roll over the inherited IRA.¹¹

Disclaimer to a Credit Shelter Trust

Most estate plans for married couples will fund a "credit shelter trust" at the death of the first spouse. The credit shelter trust will be funded with the deceased spouse's estate tax exemption amount, and by doing so, the married couple will use both of their estate tax exemptions, which in year 2002 is \$1 million per U.S. resident.¹² Due to the bull market that existed in most of the 1980s and 1990s, many estates consist largely of retirement plan assets that have been rolled over into IRAs. The dilemma is whether it is better to fund a credit shelter trust with IRA proceeds, which incurs an income tax, or roll over the IRA to a spousal IRA, thereby stretching out the IRA but perhaps also subjecting the IRA to estate taxes on the second death.

A very common estate-planning technique, which gives the surviving spouse the option of funding a credit shelter trust with IRA proceeds, is to leave IRA assets to the surviving spouse but

indicate in the beneficiary designation that should the surviving spouse disclaim all or part the IRA, the disclaimed part funds a credit shelter trust. When, if ever, would it make sense for the surviving spouse to disclaim IRA assets?

There have been several legislative developments that discourage the use of a disclaimer in this situation. Under the new tax act,¹³ individual estate tax exemption increases to \$1 million next year up to \$3.5 million in 2009, before the estate tax is repealed in 2010. As a result of this increase, fewer estates will be subject to estate tax, and therefore there is less of a need to fully fund a credit shelter trust with IRA proceeds. The new tax act also reduces the top estate tax rate,¹⁴ so even where an estate is subject to the estate tax, the tax will be less. Finally, under the new tax act, the life expectancy used to calculate RMDs will be changed to reflect the current longer life expectancies, rather than the ones issued in 1986.¹⁵

An example will help explain these concepts. Assume that in 2002, the husband, aged sixty-eight, dies survived by his wife, aged sixty-two, with an estate worth \$1.5 million, which includes a rollover IRA worth \$1 million. The IRA designated beneficiary form lists the surviving spouse as primary beneficiary, and states that any disclaimed portion of the IRA funds the credit shelter trust. If the surviving spouse disclaims \$500,000 of the IRA to fully fund the credit shelter trust, an income tax of almost \$200,000 will be incurred.¹⁶ In the alternative, by rolling over the IRA, \$500,000 of the estate tax exemption would be unused, but we are not concerned about not using this exemption because it is very unlikely that estate tax will be incurred upon the surviving spouse's death.¹⁷ In our situation, since the likelihood that there will be an estate tax due is slight, the surviving spouse, and the estate, are better off by rolling over the IRA.

Conclusion

The new proposed regulations under IRC Section 401(a)(9) shift much of the decision making regarding RMDs to the estate planner. The key date will now be December 31st of the year following the year of death, and for this reason, post-mortem planning with spousal IRAs should

become a very important part of every estate planner's practice.

Endnotes

1. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A-2 (2001). The preamble to the new proposed regulations permits IRA owners to follow the new rules in 2001, even if their IRA Custodian had not yet amended the IRA Agreement for the new rules.
2. If the IRA owner turned age 71 in their "70½" calendar year (this occurs if age 70½ comes in January through June), the life expectancy under the New Rules is 25.3; if the IRA owner turned age 70 in the 70½ calendar year (this occurs if age 70½ comes in July through December), the life expectancy under the New Rules is 26.2. See Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A-4(a)(2) (2001).
3. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A-5(c)(2) (2001).
4. Beneficiaries with no life expectancy include estates, charities, institutions, and trusts that do not comply with Prop. Treas. Reg. §§ 1.401(a)(9)-4, Q&A-5(b) (2001).
5. Under final regulations issued April 17, 2002, the date on which the designated beneficiary must be determined is September 30th of the calendar year following the calendar year of the IRA owner's death. See Reg. § 1.401(a)(9)-4, Q&A-4. The final regulations are effective for calendar years beginning on or after January 1, 2003, and can be relied upon in the 2002 calendar year.
6. Prop. Treas. Reg. § 1.401(a)(9)-1, E-5(a) (1987).
7. Under the final regulations described in Footnote 5 *infra*, the date on which the separate share must be created is September 30th of the year following the IRA owner's death.
8. In the event the surviving spouse remarries a "youngster," the actual joint life expectancy can be used.
9. Prop. Treas. Reg. § 1.401(a)(9)-4, Q&A-7(c)(3), Example 2 (iii) (2001).

10. I.R.C. § 401(a)(9)(B)(iv) governs spousal rollovers. Note that RMDs cannot be rolled over by the surviving spouse or any other IRA owner.
11. Under the final regulations described in Endnote 5, the designated beneficiary is determined as of September 30th of the year following the IRA owner's death.
12. As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax exemption per U.S. resident increases in the following manner: \$1 million in years 2002 and 2003; \$1.5 million in years 2004 and 2005; \$2 million in years 2006, 2007, and 2008; \$3.5 million in year 2009; no estate tax in year 2010; and \$1 million in year 2011. Many tax practitioners believe that future legislation will set the estate tax exemption to a figure that is between \$2 and \$3 million. *See* 26 U.S.C. § 2010(c).
13. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).
14. Under EGTRRA, the maximum estate and gift tax rate for any calendar year after 2002 and before 2010 will be as follows: 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006, and 45% in 2007, 2008 and 2009. *See* 26 U.S.C. §§ 2001(c) and 2502(a).
15. 26 U.S.C.A. § 634 (EGTRRA).
16. At the highest income tax bracket of 39.6%, an IRA distribution of \$500,000 into the credit shelter trust would generate an income tax of \$198,000.
17. Assuming that \$1.5 million represents the entire estate, at the first death \$500,000 would be placed in a credit shelter trust and \$1 million is transferred outright to the surviving spouse. Should the surviving spouse also die in 2002, her \$1 million exemption would shelter her taxable estate of \$1 million from estate tax. In later years, her estate will likely increase in value, but so should her estate tax exemption (see endnote 12). The point of the example is to demonstrate how, as a result of the increased exemptions, it does not always make sense to fully fund a credit shelter trust with IRA assets, especially now that IRA assets can be stretched out significantly under the new proposed regulations.